

**Internal Revenue Service**

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Date 12/18/96

Surname [REDACTED]

**Department of the Treasury**

Washington, DC 20224

Person to Contact: [REDACTED]

Telephone Number: [REDACTED]

Refer Reply to: CP:E:EO:T:1:LMB

Date: SEP 19 1996

Employer Identification Number: [REDACTED]  
Key District: Southeast (Baltimore, MD)

. Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

FACTS

You were incorporated on [REDACTED] as a not-for-profit corporation under the laws of [REDACTED]. According to your Articles of Incorporation, your purposes include:

- (A) To promote education, research and community service related to the care of the sick and injured, including the furthering by clinical study, laboratory research, publication and teaching of the knowledge of diseases and the application of such knowledge to the prevention and treatment of diseases;
- (B) To create clinical practice opportunities for students, residents and fellows at the University of [REDACTED], a political subdivision of the State of [REDACTED] ("[REDACTED]"), that are essential to the training of such students and postgraduate health professionals;
- (C) To provide support for [REDACTED] and its affiliated entities, including a faculty practice exempt under section 501(c)(3) of the Code;
- (D) To develop or participate in a provider network of sufficient size to manage the medical care of individuals through contractual arrangements, affiliations and practice acquisitions;

- [REDACTED]
- (E) To participate in joint ventures or other legal entities and the formation of these entities;
  - (F) To promote public health through investment and participation in a managed care health care provider network;
  - (G) To participate in any activity designed and carried on to promote the general health of the citizens of Florida; and
  - (H) To provide management services for affiliated physicians including services designed to attain economies of scale and reduce practice costs.

In essence, you were formed for the purpose of creating an integrated delivery system utilizing in part, the [REDACTED] College of Medicine ("Medical College"), the faculty practice entities associated with the Medical College ("Faculty Practices") and [REDACTED] ("[REDACTED]"), all of which are organizations exempt under section 501(c)(3) of the Code.

The Faculty Practices are organizations through which members of the faculty of the Medical College practice medicine for private patients, including Medicaid and Medicare patients. The Faculty Practices are component units of [REDACTED] and are approved faculty practice plans of the Board of Regents of the State of [REDACTED], organized to support educational research and service programs of the Medical College. The Faculty Practices bill and collect professional fees generated by the [REDACTED] faculty for the benefit of the Medical College. The membership of the Faculty Practices consists of clinical physicians employed by [REDACTED]. The Board members of the Faculty Practices consist of the clinical chairs and associate chairs of the Medical College, as well as the other representatives of [REDACTED].

[REDACTED] operates [REDACTED] Hospital, located in [REDACTED], [REDACTED] and [REDACTED] Hospital, located in [REDACTED]. The members of [REDACTED] are its Board of Directors, who broadly represent the community. The President of [REDACTED] may remove all [REDACTED]' Board members, with or without cause. As a result, [REDACTED] is effectively controlled by [REDACTED].

Your members consist of the members of your Board of Directors. Your Board is comprised of eight members, divided into the following three categories.

Category One Directors hold their position ex officio and consists of:

1. ■'s Vice-President of Health Affairs;
2. The Dean of the Medical College;
3. The Chief Executive Officer ("CEO") of the University College of Medicine Faculty Group Practice;
4. The CEO of the ■ Health Systems; and
5. The Executive Vice-President and Chief Executive Officer of ■.

The sole Category Two Director is appointed by the President of ■ and may or may not be affiliated with ■. The two Category Three Directors are individual residents of ■ appointed by ■ who are not physicians and possess no direct or indirect affiliation with ■, ■ or any affiliate thereof.

Therefore, at least five of the eight members of your Board of Directors are representatives of ■, ■ or their affiliates, and at least two additional directors are independent members of the community.

You have represented that you intend to adopt a substantial conflicts of interest policy with respect to your officers and directors.

You will act as a provider of health care services by employing physicians and operating health care facilities, directly or indirectly, as a member of joint ventures formed as partnerships or limited liability companies. You will negotiate managed care contracts on behalf of a network of health care providers you will create that will include the Faculty Practices and ■. You will also administer claims, initially on behalf of your employees and ■' employees.

You intend to develop a network of health care providers in addition to your employed physicians and the health care facilities you own directly and indirectly. You will enter into agreements with private practice physicians, hospitals, including ■, the Faculty Practices and other health care providers, to form a network of health care providers. Further, you intend to enter into joint ventures with other entities, some of which may be for-profit entities, by forming partnerships and limited

[REDACTED]

liability companies in order to create new health care providers. You will provide management services and nonphysician support services to health care providers that are part of the network you have created. You are currently a member of [REDACTED] (" [REDACTED] "), a [REDACTED] limited liability company. The other member of [REDACTED] is [REDACTED], a [REDACTED] for-profit corporation. [REDACTED] will be engaged in providing seminar programs and other professional education programs for health care professionals.

In addition to contracting with other provider entities, you will become a direct provider of health care services. You have acquired one physician practice since your incorporation. You initially entered into an independent contractor agreement with the selling physician under which he agreed to provide medical services on your behalf. This contract has since expired. You will also employ physicians to provide health care services. Currently, you employ [REDACTED] physicians. You have entered into employment contracts with these physicians to provide medical services for patients in such places as you assign. One of these physicians provides primary care services at [REDACTED]. You have entered into independent contractor agreements with [REDACTED] emergency medicine physicians to provide emergency medicine services at [REDACTED]. In addition, you are currently negotiating independent contractor agreements with an additional [REDACTED] physicians who will also provide emergency room services at [REDACTED].

You will utilize the provider network, as well as your own ability to provide health care services, to enter into agreements with various payors of health care services, including insurance carriers, preferred provider organizations, health maintenance organizations, governmental entities and or other entities ultimately responsible for the payment of health care services for enrollees ("Payors"). Arrangements with Payors will take two forms:

1. You will enter into agreements to provide access for enrollees of the contracting Payor to your network. You will receive an access fee from the Payor based on a mutually agreeable basis.
2. You will enter into an agreement with a Payor under which you will assume the obligation to provide medical services for the enrollees of a specific Payor who live in your service area in exchange for the payment by the Payor of fee per individual enrollee. In turn, you will enter into agreements with providers in your

[REDACTED]

network to provide health care services to the enrollees of Payors that will allocate the capitation payment among the members of the network you have contracted with. Certain of the health care services may be performed by your employees or independent contractors you engaged to provide medical services on your behalf. You will retain a portion of the capitation payment for your services.

You intend to participate in both Medicare and Medicaid programs on a nondiscriminatory basis. You intend to operate a community based, primary care clinic in a lower socioeconomic area of [REDACTED]. You anticipate that more than [REDACTED]% of the patients treated at this clinic will be Medicaid or nonpaying patients. You will provide outpatient care to persons registered at the clinic, regardless of their ability to pay or their lack of insurance, and will assume the risk for the cost of their inpatient care.

Currently, there are a number of managed care contracts in effect between various Payors and [REDACTED], and between various Payors and the Faculty Practices. There are also a number of additional contracts that are currently being negotiated. You expect that some or all of these managed care contracts will be assigned to you.

#### LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable, scientific or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(b)(1) of the regulations provides that an organization is organized exclusively for one or more exempt purposes only if its articles of organization (a) limit the purposes of such organization to one or more exempt purposes and (b) do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will

[REDACTED]

not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(e)(1) of the regulations states that an organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) of the Code.

In Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945), the Court stated that "the presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization will not be considered as operating exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in Code section 501(c)(3) in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. See Restatement (Second) of Trusts, sections 368, 372; IV Scott on Trusts, section 368, 372 (3rd Ed. 1967); and Revenue Ruling 69-545, 1969-2 C.B. 117.

Rev. Rul. 86-98, 1986-2 C.B. 74, involved an individual practice association (IPA) of private practice physicians whose purpose was to arrange for the delivery of health care services through contracts negotiated with health maintenance organizations (HMOs). The IPA's primary activities were to serve as a bargaining agent for its members in dealing with HMOs and to perform the administrative claims services required by the agreements negotiated with the HMOs. The Service found that the IPA did not provide to HMO patients access to medical care which would not have been available but for the establishment of the IPA, nor did it provide such care below reasonable and customary fees. Because the IPA operated in a manner similar to organizations carried on for profit and its primary beneficiaries were its member-physicians rather than the community as a whole, the Service denied the IPA exemption under sections 501(c)(4) and 501(c)(6).

Section 501(e) of the Code provides that a cooperative hospital service organization is treated as if it were exempt under section 501(c)(3) if it performs certain specific service activities enumerated in the statute for two or more exempt

[REDACTED]

hospitals and allocates or pays, within 8-1/2 months after the end of the year, all net earnings to its members on the basis of the services performed for them.

Section 1.501(e)-1 of the regulations provides that section 501(e) is the exclusive and controlling section under which a cooperative hospital service organization can qualify as a charitable organization.

In HCSC-Laundry v. U.S., 450 U.S. 1 (1981), the Supreme Court held that a cooperative laundry organization that served exempt hospitals could not qualify as exempt under section 501(c)(3) because laundry services is not one of the activities enumerated in section 501(e).

Section 1.502-1(b) of the regulations provides that a subsidiary organization of a tax exempt organization may be exempt on the ground that the activities of the subsidiary are an integral part of the exempt activities of the parent organization. However, the subsidiary is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business if regularly carried on by the parent organization.

Rev. Rul. 54-305, 1954-2 C.B. 127, describes an organization whose primary purpose is the operation and maintenance of a purchasing agency for the benefit of its otherwise unrelated members who are exempt as charitable organizations. The ruling held that the organization did not qualify under section 101(6) of the Code (the predecessor to section 501(c)(3)) because its activities consisted primarily of the purchase of supplies and the performance of other related services. The ruling stated that such activities in themselves cannot be termed charitable, but are ordinary business activities.

Rev. Rul. 69-528, 1969-2 C.B. 127, describes an organization formed to provide investment services on a fee basis only to organizations exempt under section 501(c)(3) of the Code. The organization invested funds received from participating tax-exempt organizations. The service organization was free from the control of the participating organizations and had absolute and uncontrolled discretion over investment policies. The ruling held that the service organization did not qualify under section 501(c)(3) of the Code and stated that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

Rev. Rul. 70-535, 1970-2 C.B. 117, describes an organization formed to provide management, development and consulting services for low and moderate income housing projects for a fee. The ruling held that the organization did not qualify under section 501(c)(4) of the Code. The ruling stated: "Since the organization's primary activity is carrying on a business by managing low and moderate income housing projects in a manner similar to organizations operated for profit, the organization is not operated primarily for the promotion of social welfare."

Rev. Rul. 72-369, 1972-3 C.B. 245, describes an organization formed to provide management and consulting services at cost to unrelated exempt organizations. This revenue ruling stated: "An organization is not exempt merely because its operations are not conducted for the purposes of producing a profit. . . . Providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit."

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the organization entered into consultant-retainer relationships with five or six limited resource groups involved in the fields of health, housing, vocational skills and cooperative management. The organization's financing did not resemble that of the typical section 501(c)(3) organization. It had neither solicited, nor received, any voluntary contributions from the public. The court concluded that because its sole activity consisted of offering consulting services for a fee, set at or close to cost, to nonprofit, limited resource organizations, it did not qualify for exemption under section 501(c)(3) of the Code.

In Rev. Rul. 78-41, 1978-1 C.B. 148, a trust created by a hospital to accumulate and hold funds to pay malpractice claims against the hospital was determined to be an integral part organization because the hospital exercised significant financial control over the trust. This was because the trustee was required to make payments to claimants at the direction of the hospital, the hospital provided the funds for the trust and the hospital directed where the funds from the trust were to be paid.

#### RATIONALE

1. While the promotion of health is considered a charitable purpose within the meaning of section 501(c)(3) of the Code, providing ordinary commercial services for a group of health care providers does not directly promote health. There is no broad community benefit that results from such activities. Providing these services is not a charitable activity but rather



[REDACTED]

an ordinary commercial activity. See Rev. Rul. 54-305, supra; Rev. Rul. 69-528, supra; Rev. Rul. 72-369, supra; and B.S.W. Group, Inc., supra. The management, administrative and contracting services that you provide to the non-Faculty Practice physicians in your network are ordinary commercial services for these providers.

Moreover, you have not demonstrated that the various management, administrative and contracting services that you provide to the network physicians who are not Faculty Practice members benefit the community in the manner described in Rev. Rul. 69-545, supra.

Therefore, you are neither organized nor operated exclusively for charitable purposes under sections 1.501(c)(3)-1(b) and 1.501(c)(3)-1(c)(1) of the regulations. For the same reasons, you would not qualify as an organization described in section 501(c)(4) of the Code. See Rev. Rul. 70-535, supra.

2. Under section 1.502-1(b) of the regulations, one organization may derive its exemption from a related organization exempt under section 501(c)(3) of the Code if it is an integral part of the exempt organization. To obtain exemption derivatively, two requirements must be met: (1) the two organizations must be "related" and (2) the subordinate entity must perform "essential" services for the parent. The related organization must be structurally or financially related, not just functionally related, to be considered related for purposes of the integral part theory. Section 1.502-1(b) of the regulations includes the following example of an organization that is considered as providing essential services: a subsidiary which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities.

Under the regulations, a subsidiary organization that is engaged in an activity that would be considered an unrelated trade or business if it were regularly carried on by the exempt parent does not provide an essential service for the parent. The regulations include an example of a subsidiary organization that is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization.

Similarly, if the subsidiary organization were owned by several unrelated exempt organizations and operated for the purpose of furnishing electric power to each of them, it would not be exempt because the business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt

[REDACTED]

organizations. For this purpose, organizations are related only if they consist of a parent and one or more of its subsidiaries or of subsidiaries having a common parent. An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities. See section 1.502-1(b) of the regulations.

The various services you provide to the Medical College, [REDACTED] and the Faculty Practices enhance the ability of the Faculty Practices to attract a continuum of patients with diverse medical problems to the Medical College and to [REDACTED]. The operation of the Faculty Practices contributes to the ability of the Medical College, [REDACTED] and its faculty to teach their medical students, thereby providing a benefit to the community. However, you are analogous to the example in the regulations of the electric power subsidiary that is owned by more than one unrelated exempt organization that is providing electric power to each of its owners. You are owned by three exempt organizations, two of which, Medical College and [REDACTED], are not structurally or financially related in the manner described in the regulations, and you provide services to both of these. These services, if they were regularly carried on by either the Medical College or [REDACTED] would be an unrelated trade or business. Therefore, your activities are not considered "essential services" and you do not qualify as an integral part of either the Medical College or of [REDACTED].

3. An organization that provides services for more than one exempt hospital may qualify for exemption under section 501(c)(3) if it meets the requirements of Section 501(e) of the Code. However, the exemption applies only to organizations providing the services specifically enumerated in the statute and the regulations. Since section 501(e) is the exclusive means by which a hospital service organization may qualify for exemption under section 501(c)(3), see section 1.501(e)-1 of the regulations and HCSC-Laundry, supra, a hospital service organization providing services other than those specifically enumerated in the statute, does not qualify.

The management, administrative and contracting services that you provide to physicians in your network are not the services specifically enumerated in section 501(e) of the Code. Furthermore, you do not meet the requirements of section 501(e)(2) regarding allocation or payment of net earnings. Therefore, under section 501(e), you do not qualify as an organization that should be treated as exempt under section 501(c)(3).

4. Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization will not be considered as operated exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Furthermore, an exempt organization may not be operated, directly or indirectly, for the benefit of private interests. See section 1.501(c)(3)-1(d)(1)(ii) and Rev. Rul. 69-545, supra.

The various management, administrative and contracting services that you provide to network physicians who are not members of the Faculty Practice result in a substantial economic benefit to these physicians. This economic benefit violates the proscription against substantial private benefit. Therefore, you are not operated exclusively for charitable purposes and do not qualify for exemption under section 501(c)(3) of the Code.

The economic benefit to the network physicians who are not members of the Faculty Practice that results from you providing the above services to these physicians would also prevent you from being recognized as exempt under sections 501(c)(4) or 501(c)(6) of the Code. See Rev. Rul. 86-98, supra.

5. Section 1.501(c)(3)-1(e)(1) of the regulations states that an organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) of the Code.

In Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945), the Court stated that "the presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

Neither the professional seminars and training programs that you are promoting through [REDACTED] nor the medical services that you provide to other hospitals for a fee are charitable activities because they are indistinguishable from ordinary commercial activities. The emergency medicine services you provide to [REDACTED] are not furnished on a charitable basis but are sold in an ordinary commercial manner to the Hospital that purchased these services from you. These activities reflect a substantial nonexempt purpose that disqualifies you for exemption under section 501(c)(3) of the Code.

CONCLUSION

For the reasons stated above, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key district office. Thereafter, any questions about your federal income tax status should be addressed to that office. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service

CP:E:EO:T:1, Room 6514  
1111 Constitution Ave, N.W.  
Washington, D.C. 20224

[REDACTED]

For your convenience, our FAX number is [REDACTED].

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representatives.

Sincerely,

(signed) [REDACTED]

[REDACTED]  
Chief, Exempt Organizations  
Technical Branch 1

[REDACTED]

bcc:

[REDACTED]

[REDACTED]

	Initiator	Reviewer	Reviewer	Reviewer
Code	CP:E:EO:T:1	CP:E:EO:T:1		
Surname	[REDACTED]	[REDACTED]		
Date	9/16/96	<i>By Darling</i> 9/17/96		